

The Prospects for the European Economy in 2011

2011 could be a make or break year for the European Union and the Eurozone economies. It seems that the bigger strong economies like Germany are expected to show strong economic growth rates. Germany which is the European Union's biggest economy showed strong export driven growth and a decrease in unemployment, fuelled by strong export expansion to emerging economies such as China, and this trend can be expected to continue. However, the smaller weaker peripheral economies of the Eurozone are expected to experience severe austerity and budget spending cuts, and rising unemployment. Estonia with its small economy and population joined the Euro on 1st of January this year, and managed to follow all the EU's economic criteria, including a budget deficit below 3% joined the Eurozone as its newest and 19th member, and gave the Euro zone a brief temporary vote of confidence.

If the Euro is to survive the Eurozone's richer members like Germany and France will have to bail-out the smaller countries with troubled and indebted economies, such as the PIGS countries (Portugal, Ireland, Greece, and possibly Spain). 2011 will bring little prosperity to the heavily indebted Eurozone countries on the periphery, as they face prolonged economic austerity and high levels of unemployment, cuts in wages and benefits. If these countries had their own currencies and monetary policies their governments could have raised their exports and employment through devaluation of their currencies, and if they have their own monetary policies they could lower interest rates to stimulate a return to economic growth.

A major problem with the Euro area is that it is a currency area that involves too many countries with differing levels of economic and social development, and it is hard to have a single interest rate and monetary policy which can benefit economies with different development levels. For such a monetary union to work in the long-term would require much closer coordination and harmonisation of fiscal policies, and perhaps common tax policies, but this is hard to achieve in the absence of a federal political authority. Eurozone leaders said recently that there is a strong need for a common European economic policy; this logically leads to the idea of a fiscal union to complement the Euro as a common currency, and to ensure financial and monetary, and economic stability in the long-term. Britain can cooperate in a common European economic policy. But as we are for the time being outside the Euro area there are limits to British participation. As most of Britain's trade is with the EU, and as British banks and financial institutions and the City of London are heavily involved in Europe economically and financial Britain has a close interest in the success of a common European economic policy.

The British economy is expected to grow, although slowly, in 2011 as the budget spending and public sector jobs cuts will start to bite, but the £83 billion public spending cuts to reduce the country's budget deficit and £1 trillion public debt is likely to mean slow economic growth, and unemployment to hit 10%. The Leader of Britain's Labour Party Ed Miliband correctly recently said in the House of Commons that Britain was in the slow lane of economic growth compared to the rising economic growth of GDP's and exports of the leading Eurozone bloc economies, Germany, and France. This will lead to rising social discontent, protests again by the students, and a wave of strikes by highly organised public sector unions over severe job losses. Britain has started to suffer from inflation alongside high unemployment. The fact that Britain is not a member of the Eurozone and has its own independent currency and monetary policy the Pound Sterling means that the depreciation of the Pound has boosted exports of manufactured goods and services. However, despite being out of the Euro Britain is not immune to the Euro financial and economic problems, as the

European Union is the UK's biggest trade partner, and many British banks are exposed to Eurozone banks, and any default of sovereign debts would damage the City of London British-based banks and the British economy and undermine economic recovery and growth. Therefore the Conservative-dominated Coalition Government has supported European efforts to resolve the Euro-debt financial crisis, and to provide a permanent bail-out fund to help the struggling poorer peripheral southern economies of the Eurozone. The European Union and especially the richer Eurozone members must show economic and social solidarity with the poorer troubled weaker economies, as their economic and financial collapse could have

devastating effects upon the rest of the European Union, including non-Euro members such as Britain. The global economic and trading system is unbalanced, and there is a need for greater financial and trade balance.

Big emerging countries like China must focus more upon expanding domestic consumption and standards of living and reducing saving, and their huge balance of payments surpluses and financial surpluses, and also appreciate their undervalued currency. In the future the USA needs to boost its savings, and reduce its huge trade and budget deficits. A more creative flexible solution is needed to finally end the economic recession hurting the economies of America, and Europe. At the last G20 meeting in Paris hosted by the G20 President this year, France, China adopted a more harder line and said that its economic and currency policy were its own business, which is a strange response to global economic issues for the world's second biggest economy. The American Government at the same G20 meeting raised the question of global financial surpluses, as did the host country's France's President Sarkozy, and British Chancellor George Osborne. The meeting also debated and expressed concern at global inflation, and the rise in global food and commodities prices which could harm the pace of global economic recovery, and affect the poor of many developing countries, including big emerging economies such as China, Brazil, and India.

Economic recovery is expected to continue in Europe in 2011 but at a slower pace than the United States. Global inflation has emerged as a serious problem, there is a fear of world food shortages which are causing large rises in food prices, and also world oil prices in February 2011 reached \$100 a barrel due to the political crisis in Egypt and the instability of Middle east oil producing states, this could all impede or act as a brake upon the economic expansion of Europe. Inflation is also hurting the emerging economies, and threatens their breakneck economic growth rates, and could lead to wide social discontent in China and India, such as industrial strikes and political protests.

The economic outlook for the European Union is a mixed picture, the bigger EU economies are expected to show a growth in their GDP's, albeit slowly. However, the fate of the big Eurozone economies is linked with those of the smaller struggling economies, which have a serious problem of debt, very high unemployment, and a lack of business confidence. Therefore the European Union's bigger and richer countries have no choice but to provide financial assistance and support to the struggling PIGS economies, which they have done so far. China has stepped into the breach recently and said it would support the Spanish economy, and purchase Spanish government bonds. However, China may have its own agenda and wants Spanish support to overturn the European Union's arms exports ban to China. The Euro is not out of the woods yet, and the sovereign debt problem of Spain is not over, and is extremely serious as Spain has the EU's 5th largest economy.

The American economy is expected to show a slow recovery, and its GDP is expected to show a 3% increase. However, unemployment is expected to fall more slowly than during past economic recoveries. The Chairman of the US Federal Reserve Bank recently said that the American budget deficit and public debt is too high and unsustainable in the long-run. However, it is hard to get political agreement in the Congress, the Republican majority is opposed to tax cuts, while the Democratic minority is opposed to any cuts in government spending, a gridlock ensues. However, as the world's largest economy and with the main reserve currency the US dollar its budget deficit represents 11% of its GDP, compared with the weak peripheral economies of the European Union with only 7.5% of their collective GDP's.

However, unlike them world investors have confidence in the big American economy, which has freedom to control its interest rates and monetary and fiscal policies, and exchange rates. The smaller and weaker PIGS are locked into the euro and lack economic, monetary and exchange rate freedom to get out of their economic and financial crisis, which threatens the stronger Eurozone economies banks and financial systems. They represent a small proportion of the Eurozone's collective Gross Domestic Product and they can be bailed out by an EU bail-out fund bankrolled by richer bigger countries like Germany and France, although Germany seems reluctant to transfer more financial resources to the weaker and troubled

Eurozone economies, as there is considerable opposition from the German voters.

The European Union's economic and sovereign debt troubles are far from over. The EU will be required to provide fresh money for a new bail-out of the Greek economy, it has provided alongside the IMF a big \$116 billion loan for Portugal, and last year a huge rescue package for Ireland. There is the strong possibility that Spain will be in a similar situation, and as it is a bigger economy more money would need to be loaned. The public finances of European Union countries are already stretched, and it would be hard for a country outside the Eurozone such as Britain to gain public support for such a mega-loan.

However, despite all these factors the writer believes that economic expansion and growth will move ahead in Europe and the United States. There is evidence that in Britain manufacturing industry's growth is leading the recovery. Europe and America need to invest heavily in renewing their ageing and decaying infra-structure, which would create a lot of jobs. Both economic blocs need to invest heavily also in education and technology, and in green industries to meet the economic challenge posed by China and India.

It seems unfair that private debt in Europe should become public debt, and in order to bail-out troubled banks involved austerity and sacrifices and unemployment for those not responsible for the European sovereign debt crisis. The age of austerity led to serious social unrest across Europe in 2010 in Greece, Spain, France, and Britain. There is a real danger that savage cuts in the budget deficits of weaker EU economies could lead to acute political and social instability, strikes, and even violence, especially in the smaller and weaker PIGS economies, which could also spread to Spain, France, and even the United Kingdom.

In Britain opposition to the Coalition Government is growing, and even recently Sir Richard Lambert the head of Britain's biggest business organization the CBI (Confederation of British Industry) attacked the Coalition's lack of vision as to what the UK economy might become, and criticised their failure to adopt policies that would support the growth of output and employment, which would also expand tax revenues. Len McCluskey the new Secretary General of one of Britain's largest unions Unite agreed strongly with Sir Richard Lambert's comments.

The outlook for the European economies, apart from Germany, is not good. However leading developed economies such as US, Germany, and Japan are expected to show strong economic growth in 2011 and unemployment is expected to drop. The emerging economies are expected to continue to show strong growth, but the pace may be reduced due to the need to rein in high inflation, and the overheating of the Brazilian, Chinese, and Indian economies. Some leading economists talk of a "three speed economy" in which the emerging economies grow by 6% in 2011, the US economy by 3%, and the Eurozone by a lower speed of only 2% this year. However, there is still a fear in Europe that the Spain and even Belgium with its political vacuum and high public debt could face an economic and financial crisis similar to Ireland and Portugal in 2010, and the Eurozone may have to bail them out. The Governor of Britain's Bank of England Mervyn King has recently said that inflation is likely to rise to 4 to 5 % over the next few months, and it was already in December 2010, 3.7%. He also said that take-home pay for British workers was in 2010 less than in 2005 due to the effects of inflation. There is a real danger of double dip inflation in Britain. Unemployment is also high with 2.5 million unemployed in January 2011, which is 7.9% of the labour force, and 20% of graduates are unemployed. The UK economy shrank by 0.5% for the last quarter of 2010. Youth unemployment has emerged as a serious social problem again.

Europe's economic recovery is still patch with the powerful and largest European Union economy Germany steaming ahead with strong economic growth and export performance, with the problems of the southern indebted troubled economies still unresolved. France and Germany have strongly backed the survival of the Euro, but for the monetary Union to recover stability in the long-term there must be large fiscal transfers from the wealthy inner core of Eurozone countries Germany and France to provide the money.

Writing this paper from London Europe's biggest financial centre it seems that the underlying problem of the British economy is that it has become too unbalanced, and that the risk posed to the UK economy from a international banking sector too large compared with the size of the British economy, and the fact that the British economy is not diversified enough. The solution would be a rebalancing of the British economy towards a smaller banking and financial sector, and the modernisation and regeneration of the manufacturing and export industries, which would create more jobs and reduce economic risk perhaps.

Britain needs to relearn its manufacturing skills to produce high quality and high value niche manufactured goods like Germany, and to sell more industrial products to the emerging economies, such as China, India, Brazil, Russia, Indonesia, and many other growing emerging markets. Britain's manufacturing sector is showing signs of recovery, but more needs to be done to upscale and strengthen this sector, and to rebalance the United Kingdom economy towards a larger high-tech industrial sector. Manufacturing growth worldwide is showing strong buoyant growth globally including Britain and the Eurozone.

At present the centre right parties constitute the majority of the EU's governments, especially the EU's biggest economies Germany, United Kingdom, and France. The democratically-elected European Parliament has a large majority of centre right conservative and liberal parties, which favour tough economic austerity across Europe, and the rolling back of state spending and the state's role in the economy. The tough austerity and public spending cuts is producing a serious economic and social crisis, which will lead to rising social and political protests across Europe, this could undermine European economic and political stability and democracy, unless economic recovery and a large decline in unemployment soon kicks in. The Irish people have voted against the recent EU/IMF loan bail-out by rejecting overwhelmingly the Fianna Fail dominated Irish Coalition Government, which had negotiated and favoured the loan bail-out and austerity package, and was blamed for both the property bubble and the Irish financial meltdown, and gave a huge majority to both Fine Gael and the Irish Labour Party which strongly endorse a renegotiation of the EU/IMF bail-out loan and austerity package. They are expected to form a new coalition and to call for the European Union to cut the interest rate for the loan, which is a high 5.8%, and to allow the loan to be repaid over a longer term. In the interests of economic and political stability, and European economic and social solidarity a softer and more gentle approach needs to be adopted for Ireland, and for Portugal which faces similar debt problems, and possibly even Spain. However, the Eurozone led by German intransigence has not agreed to a softer more "Community solidarity approach", as Germany would have to make the largest financial transfers to debt ridden economies.

The economic meltdown in Japan following the devastating loss of life, and damage to the infrastructure following the shocking earthquake, the tsunami and the nuclear meltdown had damaged confidence in Japan, and as the world's third biggest economy and a huge foreign investor worldwide, will dampen the already fragile global economy for a time.

As Britain is not a member of the Eurozone there is wide political opposition from many voters, as well as the media, and Eurosceptics to Britain's soaring £9 billion budgetary contribution to the European Union budget to help multi-billion pound Eurozone bail-outs for Portugal, Greece, and Ireland. This is especially so when many ordinary British people are suffering from austerity, high unemployment levels, and a drop in living standards. Germany under Mrs. Angela Merkel will face a political meltdown due to the unpopularity of the any big bail-out, yet this may be necessary to keep the Euro project afloat, and many German banks have heavy outstanding loans to Portugal and Greece, and could be badly hit by debt default. However, German banks must accept to share some of the pain. However, a monetary union like the single European currency so far lacks any strong permanent institutional problem to resolve Europe's sovereign debt crisis, and given there is no European fiscal union to complement the European Monetary Union it is very hard to resolve, and the financial markets are fairly nervous reflecting this anxiety.

Britain's recent budget unveiled by the Conservative-dominated Coalition Government was certainly not pro-growth or jobs as the Chancellor George Osborne claimed to Parliament, it focused more upon micro-

economy. The squeeze upon the British economy will lead to prolonged fall in living standards, low job creation, and slow growth and economic stagnation for some time.

The economic and sovereign debt crisis affecting the Eurozone is still far from being resolved. There is a feeling that the debt burden of Greece, Ireland, and more recently Portugal requires an easing of conditions, trimming of interest rates by the EU, and a rescheduling of the debts of so-called PIGS countries to a more longer-term to allow their economies to grow again, even if slowly. The German and French economies showed strong economic recovery especially in their manufacturing industries in April, while the weaker peripheral economies lagged behind. But economic growth slowed in the Italian and Spanish economies.

Europe's economic troubles and the sovereign debt crisis is far from being over. Portugal's Prime Minister Jose Socrates resigned as the Parliament rejected a very tough austerity plan. Portugal's economy has only grown by a tiny 1% over the past decade. The fear is that the much bigger Spanish economy may be forced into a similar situation soon. Portugal's caretaker Premier Jose Socrates reached an agreement on a 78 billion Euros (\$116 billion, or £70 billion) bail-out by the IMF and the EU of the Portugal's economy. Portugal will be allowed a longer time to achieve its budget deficit targets; however the medicine is still harsh. In 2010 Portugal's deficit was a very high 9% of GDP. Portugal will have to cut its deficit by 5.9% this year, followed by slimming to 4.5% in 2012, and 3% in 2013. Portugal has received easier conditions for its \$116 billion bail-out deal from the EU and the IMF, as it does not have to change the minimum retirement age, no cuts in public sector pay, and no sackings of state employees. Deficit reduction targets were more lenient. There is still a fear that contagion may affect the much bigger and more populous neighbouring Spanish economy. There is talk that the Greek bail-out in 2010 has now worked out. In Finland there is strong opposition to the bail-out, where it has become a big issue in the establishment of a new coalition government following the elections there in April.

The Eurozone is at a crossroads if it does not show the requisite community economic and social solidarity, and either richer countries transfer money to struggling debt laden periphery economies, and trim interest rates with easier conditions enabling their economies to grow again, and repayment of loans over longer time frames, or the whole edifice of the Euro monetary union project will collapse. In its place there will be smaller rich inner core of current richer northern Euro members such as Germany, France, Netherlands, Belgium, Luxembourg, and the smaller struggling weaker economies will have their own currencies and monetary and fiscal instruments and policies again. They would be able to devalue their currencies to expand exports, and vary interest policies, and pursue expansionist economic policies to regrow their economies. This would be a jump into the unknown, and spell the end of a wider economic and political integration and union.

Europe's politicians and central bankers and economists need to debate the issue further.

Britain's economy is in the European slow lane as Labour Leader Ed Miliband recently suggested, Britain's economic growth levels are low compared to the booming German and French economies. Our public finances are in good shape compared with the weaker Irish, Portuguese, and Greek economies. The severe austerity and public spending cuts adopted by the right-leaning Con/Lib Dem Coalition are doing severe damage to the UK economy, they are unnecessary, and lead to slow growth and high unemployment.

The Eurozone's financial crisis is far from over as the bond markets are fearful of a Greek default. The recent bailout of Portugal by the EU and the IMF indicated a softer approach to resolving the country's structural deficit and public debt problem to allow the country to grow again thus be in a better position to repay its creditors.

A Greek default could throw the Eurozone countries into economic turmoil as the financial markets would cause the Euro to fall in value, and also downgrade the credit ratings of weaker peripheral countries making it more difficult for their governments to finance their borrowing.

The writer believes that Angela Merkel is correct to suggest a common European Union candidate to fill the

vacancy caused by the recent resignation of IMF Chief and former French Finance Minister Dominique Strauss Kahn, especially as the Eurozone faces a serious debt and financial crisis. Perhaps ex British Prime Minister and Minister of Finance Gordon Brown would be an excellent choice given his wide experience, and his high profile on the global financial stage. However, it seems that he is unlikely to be chosen due to strong opposition from the Conservative -dominated CON/Lib Dem Coalition Government led by the Chancellor of the Exchequer George Osborne, who have given strong backing to the current French Finance Minister Cristine Lagarde, who is now the candidate likely to be backed by the European Union as the next Managing Director of the International Monetary Fund.

There is evidence of a two speed Europe with strong economies like Germany and France powering ahead, and the weaker peripheral economies such as Greece, Portugal, Ireland, and now Spain having negative and very slow economic growth and high unemployment levels. The recent huge demonstrations in Madrid and other main Spanish cities against austerity and high unemployment and raising pension age by thousands of young unemployed young people, was not organised by Spain's traditional political parties or the trade unions. The recent huge defeat of the ruling Spanish Socialist Government on Sunday 22nd of May was against the government's tough austerity policies and cuts in public spending cuts, high unemployment, and stagnant economic growth.

According to Eurostat, the European Union's Gross Domestic Product as a whole grew by 0.8% during the first quarter of 2011 compared to the last quarter of 2010. However, if one compares it with the first quarter of 2010 the European Union's growth rate in its GDP was 2.5% higher in the first quarter of 2011. During the first quarter of 2011 the German economy grew by 1.5%, and France, Belgium, and Austria GDP rose by 1%. The Netherlands grew by 0.9%. This is the fast lane, although much slower than the growth of the GDP's of BRICS (Brazil, Russia, India, China, and now South Africa). The slower growth weaker European economies grew as follows: Greece(0.8%), United Kingdom a low 0.5%, Spain a very low 0.3%, Italy only 0.1%, and Portugal experienced a large reduction of -0.7%; clearly a two speed Europe is a reality.

Britain is not in the high speed growth lane of the EU, nor in the low speed economic growth of the weaker indebted peripheral Eurozone economies, but it seems to be in between. The March 2011 British Budget presented by the Chancellor George Osborne was not a budget aimed at expanding the economy or job creation, it seemed to be more economic austerity like the 2010 Budget, and it seems to follow the misconception that public spending and active engagement of the State in the economy is wrong. The recent strong recovery in the political fortunes of the Labour Party in the elections to the English councils, and the Welsh Assembly and the complete defeat of the Coalition partners of the Conservative Party the Liberal Democrats showed that the public spending cuts, rapid deficit reduction, rising unemployment, and cuts in public services are widely unpopular and strongly opposed by most British voters.

A major problem with the Eurozone which is not fully discussed is that a monetary union with freedom of movement of goods, labour, and capital with members at different levels of economic and social development needs fiscal transfers to the poorer countries and regions, which logically may lead to a fiscal union. Germany is opposed to this, as are many other countries as they would lose freedom over their fiscal policies and public expenditure. It may imply greater economic and political integration than is currently politically acceptable by its 27 member states, especially given the growth of the Eurosceptics across Europe. The United States is an economic, political, fiscal, and monetary union and there are fiscal transfers of incomes and public spending from wealthier regions to poorer regions and cities, this is politically acceptable because it is a single democratic country with a common language.

A lesson needs to be drawn from the current European economic crisis is that a new different approach is needed, and that in the case of Greece a softer restructuring of its huge debt is required, and that all the so-called weaker indebted PIGS economies need greater European Union common economic and social solidarity. Germany as Europe's biggest economy which has greatly benefited so far from the Eurozone must be willing to act as the leading paymaster in any European bailouts expected. Too much stress upon economic austerity and cutbacks in public spending and jobs will reduce tax revenues and undermine

economic growth making the economic situation across Europe even worse. It seems that a two speed Europe has become a reality with the stronger faster growing Eurozone economies such as Germany and France showing strong economic growth rates, higher and growing per capita income, and strong export growth especially for Germany. Foreign investment in Europe was higher than at any time before the onset of the global financial and economic crisis in 2008, while the weaker peripheral economies are suffering economic stagnation and slow economic growth if at all. Germany may be unhappy about big fiscal transfers to the weaker PIGS economies, but this is necessary to avoid the collapse of the Euro, and of the European project.

Michael Kain, 25th of May, 2011.